DOW THEORY LETTERS INC.

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THE MARKET: The week ending October 9 should probably go down in the books as a technical market "spectacular." On October 8 (see later section of this Letter) the A-D ratio made history by finally hurdling its May, 1963, peak. On October 9 the Rail Average (after a 2 1/2 month lag) rallied above its July 17 peak to an all-time high — thereby confirming the optimistic indications of the Industrial Average (see Chart 1). Even the D-J Utilities got into the act by setting an all-time high of their own.

From the standpoint of Dow's Theory, a bullish signal has been given and the primary trend has been reconfirmed as up. And although each successive bullish confirmation should be accorded less validity than the previous one (i.e., eventually a "bullish signal" will be given at or near the ultimate top) there is no questionning the fact that the bull trend remains in force.

Two phenomena are worthy of particular note at this time. First, the huge "broadening formation" (which has been discussed here on many occasions) now appears to be pushing out above its upper trendline (Chart 2, Page 2). Such a breakout would ordinarily be considered bullish and even highly speculative if it were not for the fact that the momentum of the rise now appears to be ebbing. Normally, I would expect an upward penetration of the hugh structure pictured on Chart 2 to be accompanied by sharply increased momentum, but as seen on Chart 5 ("Momentum Index") this is not the case. Thus we have a difficult problem: a breakout and an apparent bullish resolution of a broadening pattern — but the breakout is occurring in the face of steadily decreasing momentum. Could this seemingly bullish penetration be a false move? We should know the answer soon.

Despite the Momentum Index, it is nevertheless remarkable that the Averages have pushed out in the face of the current international news. Latest polls show the Labor Party moving to the lead in the British election, and a Labor victory would certainly put the pound to the test. The Labor Party's "potential" Chancellor of the Exchequer has already been quoted as ready to fight the British balance-of-payments problem with higher interest rates. The British bank rate is now 5%, but there is little doubt that the rate will go to 6% or even 7% (as in 1961) following the election. Such fiscal "belt tightening" would be bound to exert pressure on interest rates here (see Letter 260) — but if our

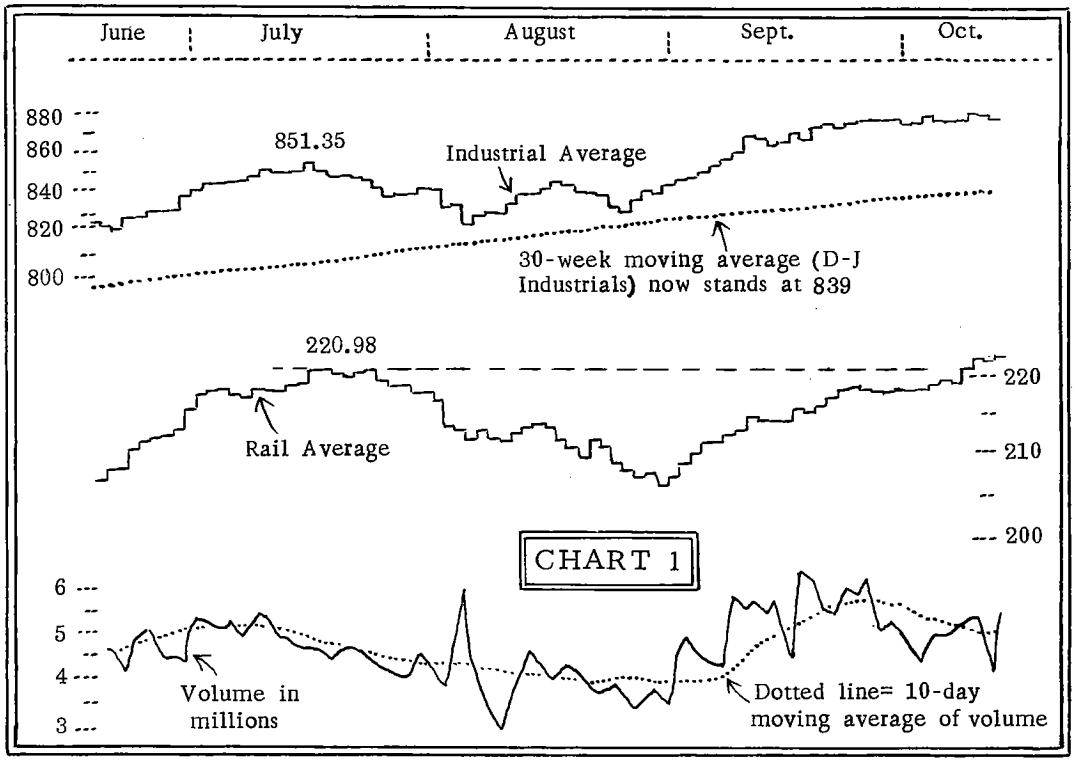
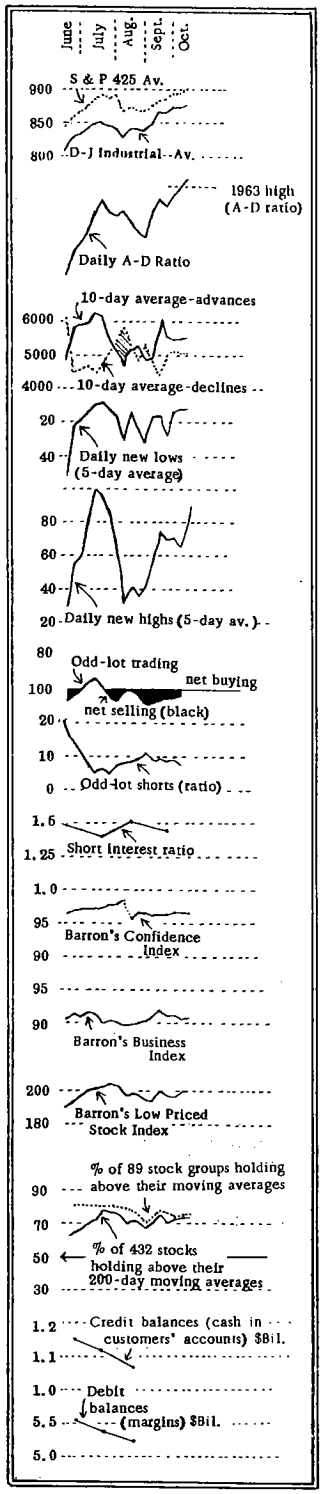


CHART 1



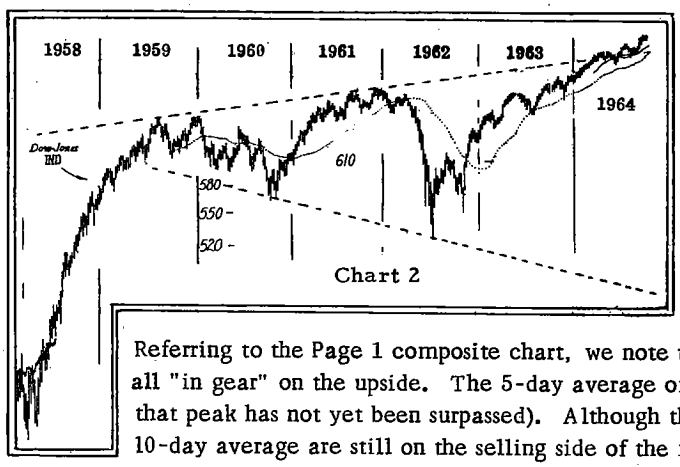


Chart 2

market knows about it, it has not yet provided us with any broad hints.

As this Letter is written (Thursday, October 15) the market is showing little inclination to follow up on its upside breakout of last week. Investors are undoubtedly waiting to assess the results and implications of the big election in Britain before making their next decisive move.

* * * *

Referring to the Page 1 composite chart, we note that the D-J Industrials, the S & P "425" and the A-D ratio are now all "in gear" on the upside. The 5-day average of daily new highs is approaching the 99 peak recorded in July (but that peak has not yet been surpassed). Although there has been a recent sprinkling of "buy" days, odd-lotters on a 10-day average are still on the selling side of the market. Barron's Confidence Index has remained in a sideways range since April of this year; consequently this Index should be considered trendless. Of 89 S & P stock groups, 72 (81%) are holding above their moving averages, and of 432 individual stocks, 320 (74%) are holding above their moving averages. Thus these two breadth studies are still well above the critical 50% level, and they are therefore confirming the other positive technical aspects of the market.

The large number of analysts and services who are forecasting "all clear and rosy" into mid-1965 and beyond constitutes one of the most disconcerting aspects of the current picture. The declining debit and credit balances (see Letter 267) and the dangerously low yields afforded by common stocks at this time plus the duration of the current rise all suggest that trouble could as easily materialize this year as next.

EXTRAORDINARY BREADTH: On October 9 the daily A-D ratio rose above its May, 1963 peak. In so doing, it pushed out of a 17-month "trading range" and this extraordinary movement can be seen on Chart 3. Over the past thirty years all major peaks in the A-D ratio which were not followed within five or six months by new highs (in the A-D ratio) constituted important warning signals. We see this over and over again — in the peaks established by the A-D ratio in 1937, 1938, 1941, 1946, 1948, 1953, 1956, 1959 and 1961. Each one of those peaks in breadth was followed by subsequent trouble in the market. Furthermore, each of these breadth peaks were followed by substantial new lows in the A-D ratio — prior to the next major market rise.

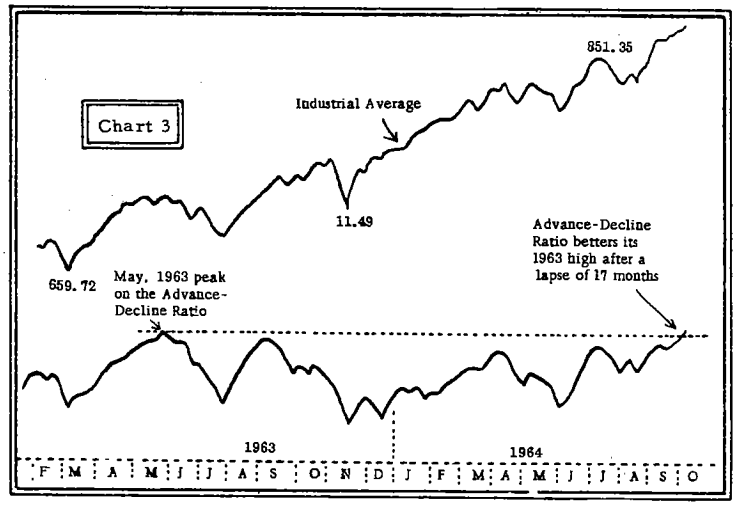


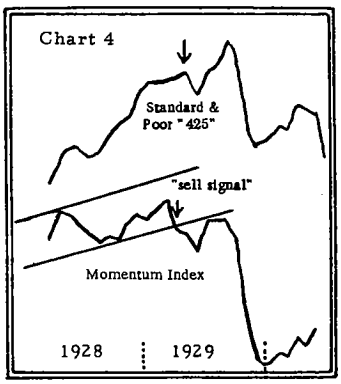
Chart 3
851.35
Industrial Average
11.49
659.72
May, 1963 peak on the Advance-Decline Ratio
Advance-Decline Ratio betters its 1963 high after a lapse of 17 months
1963
1964
F M A M J J A S O N D J F M A M J J A S O

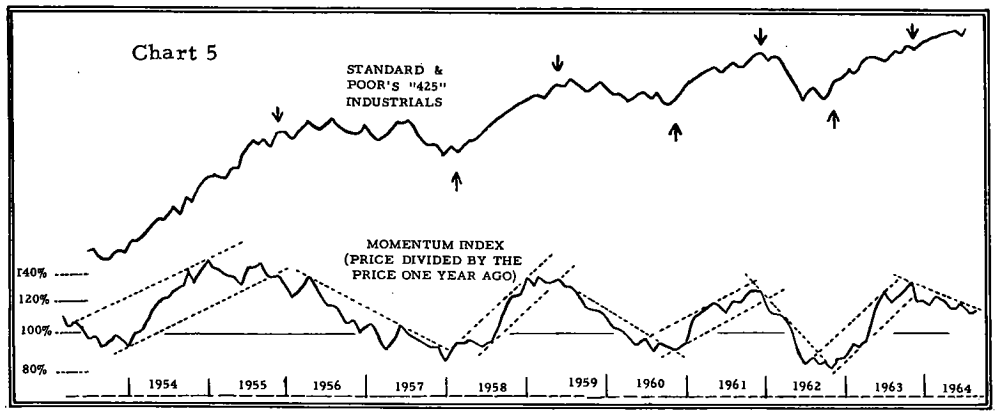
Now we come to the current situation. In May, 1963, the A-D ratio recorded a peak (Chart 3). A long trading range in breadth followed, bordered on the downside by the low point (November) recorded during the "Kennedy assassination panic." A full 17 months of generally unsatisfactory breadth followed the 1963 peak, and then on October 9, 1964, the A-D ratio (on its fourth approach to the 1963 peak) pushed to a new high. Thus history has been made.

What significance of the belated new high on the A-D ratio? In this writer's opinion, the new high in breadth constitutes another point in favor of the "final blow-off" thesis. It would be hard to conceive of this market going substantially higher without the rise taking the form of a speculative blow-off. Furthermore, it was difficult to envision a speculative explosion without a new high in breadth. With the new high in the A-D ratio, we are now technically closer to potential "madness in the market."

MOMENTUM INDEX: Letter 253 presented the Momentum Index (M.I.) and I promised to attempt to update this indicator each month (apologies for the August omission). This index is arrived at by dividing the current (end of the month) price of the comprehensive Standard & Poor 425 Industrial Stock Average by the price of that same Average exactly one year ago. The resultant figure provides us with a ratio of this month's price as compared with the price of the "425" one year ago.

As long as the index is above 100 we know that the "425" is above its level of a year ago (the converse is true if the index is under 100). But it is the direction of the index which interests us most. A forty year history of the M.I. demonstrates that the ratio numbers tend to form distinct and extended channels. Note that eight such channels are depicted on the accompanying chart. As a rule, a penetration of the index above or below a channel implies a definite change in the direction of market





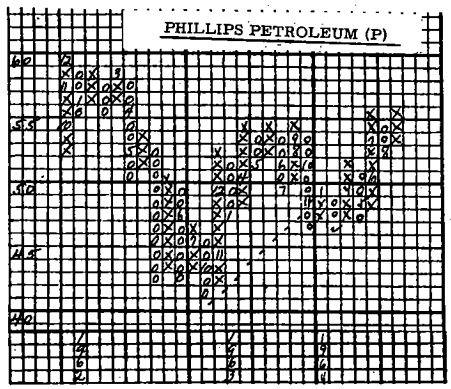
momentum (the actual channel penetrations are identified by arrows on the chart).

It is well to remember that a change in momentum has usually preceded an actual change in market direction. Furthermore, most of the channel penetrations of the past were followed by market reversals within one to six months. The time span on occasion has been considerably longer, however. For instance, in 1951 there was a 12 month lag between a channel penetration and a market top; in 1955 there was an 18 month lag.

The M.I. (Chart 5) recorded its most recent peak of 134 in October, 1963. Two months later, in December, it violated its 1962-63 channel. Ten months have elapsed since then, and there has been no evidence of a reversal in the major market averages. Nevertheless, the M.I. represents a fundamental market concept and unless or until it reverses or forms a definitive upward channel, we must conclude that this indicator is flashing a long-term signal of danger. (The latest or end of September reading for the M.I. is 118. This is slightly above the August reading, but as seen on the chart the M.I. is still holding within its downward channel).

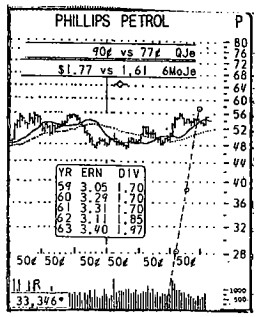
* * * * * *

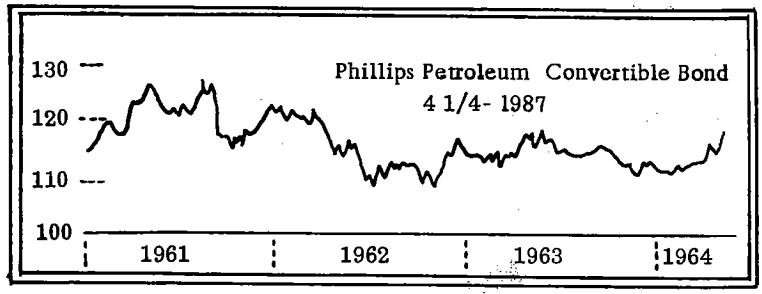
As an added note, it is a fascinating fact that the final "blue chip blow-off" in 1929 occurred following a downside penetration (the "danger signal") of the M.I. (see Chart 4). The peak in the M.I. was struck in March, 1929. In April the channel was penetrated. During July through September as the blue-chips surged, the M.I. rose just under its channel. In October the M.I. and the market dropped sharply lower and the bear market was underway.



STOCKS: Any broker will tell you that the public hates convertible bonds. They don't understand them; they're afraid of them; they won't take the trouble to find out about them. Actually, convertible bonds have many advantages and very few drawbacks. Any "pro" will take a position in a convertible (all things being equal) before he will take a position in the common stock of the same company. Not the least attraction is that a bank or a brokerage house will margin an AA rated convertible up to 90% (and this is the way some of the great market fortunes have been made).

In Letter 262 I recommended Phillips Petroleum convertible bonds (4 1/4 of 1987). The bonds were then 117 (actually $1,170 but bonds are always quoted in hundreds—not thousands) and they have since moved to a high for the year of 119. Each bond is convertible into 20 shares of Phillips common. Phillips common is now selling at about 56, which means that the bonds are "worth" 112 (i.e., 20x56). Since the bonds are selling at 119, the buyer is paying a 7 point premium over the conversion price—not too much of a premium for this AA (high quality) bond. Obviously, the point now is —

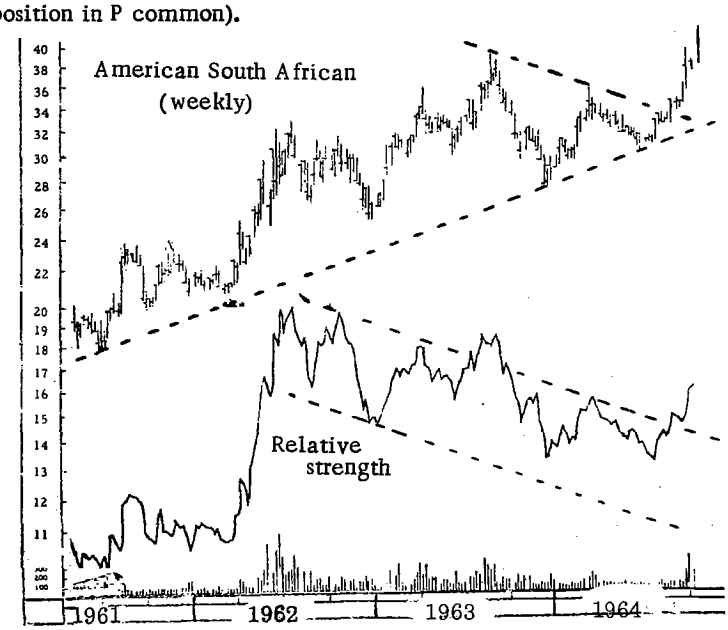




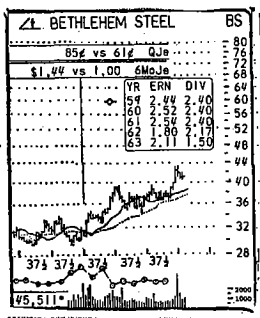
how good does Phillips common look?

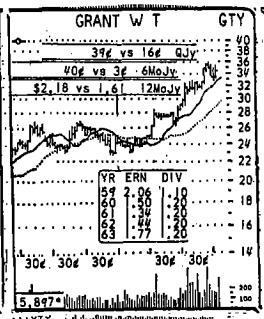
The answer is very good. Note on the point & figure chart that at 56,P has broken out above a previous triple top. The P & F "count" is now 62 (which of course is strictly theoretical) but if the stock did go to 62 the bonds would have to rise to 125 even without any premium. The small weekly chart shows P holding above its 30-week moving average (now 52), and this week rising above its 10-week moving average (now 54). As an added point, it is worth noting that P was the sixth largest addition to fund accounts over the past month (funds purchased $5.4 million worth of P). Over the past three months funds purchased $10 million worth of P. In the writer's opinion, Phillips convertibles now represent one of the best hedges against any important upside action from here. I have updated the bond chart of P (from Letter 262). Note how strongly the bond holds on the downside. Even in 1962 with P common at 42, the bond tended to hold around 109. CONCLUSION: Phillips convertible represents one of the most conservative but attractive commitments at this time (as a final aside, brokerage commission on bonds run $2.50 per bond, a rather attractive price for getting a position in P common).

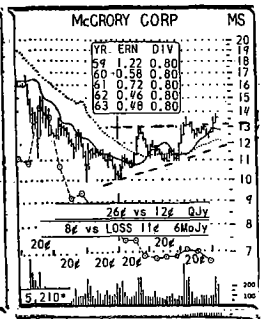
American South African (an investment trust holding largely S. African golds) was recommended strongly in Letter 263 at a price of 34. The stock has since registered a massive breakout to all-time highs. One of the best holdings of this trust is the S. African gold mining stock, President Brand (over-the-counter). In the most recent 12 month period, Pres. Brand paid out 85¢ (after S. African Taxes) equivalent to a yield of 9.2%. Pres. Brand is a real value and buy (see last Letter on S. African golds). If you buy it, ask for an American Affidavit attached to avoid possible new American tax.

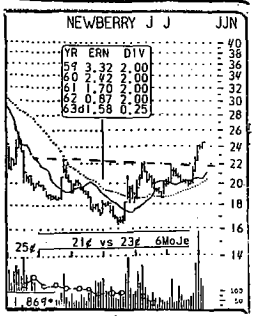


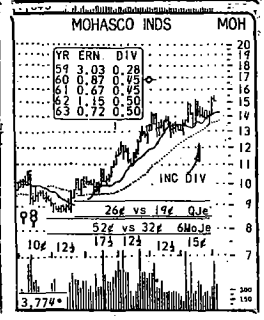
FOLLOW-UPS: Subscribers have asked where I get information on insider and fund buying and selling. Easiest place is the new TSR service put out by my friends at Indicator Digest, Palisades Park, N.J. 07650. Bethlehem Steel still attracting fund buying with 204 thousand shares purchased by funds during past three months. I still like BS best of the Steel group. McCrory, Grant and Newberry have all been recommended in the improving Variety Chain group. Of the three, only Grant shows insider and fund buying (over the past three months insiders bought 16 thousand, funds 34 thousand shares of GTY). I still think GTY is a buy. Newberry and McCrory displaying good price action and I still like them too. Mohasco (back in Letter 248) now acts particularly well and has attracted 83 thousand shares of fund purchases (as well as a little insider purchasing) over the past three months. Burroughs with heavy insider buying during the past three months has reacted back to its 10-week moving average at 26 1/2. Volume has been contracting on the decline, so we'll keep our fingers crossed on this one. Crowell Collier also attracting mild insider and fund buying—stock reacting after pushing out of large triangle. Lowenstein was strongly recommended in Letter 239 at 13. It is now 18, and this largest of all cotton fabric producer is now diversifying into other fabrics. The writer knows this company well; it can be a real earner in a good textile market (which we now have). I continue to like LST.

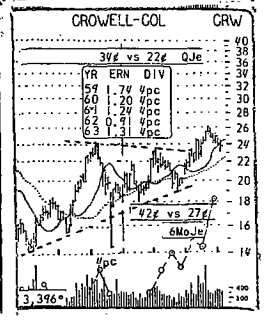


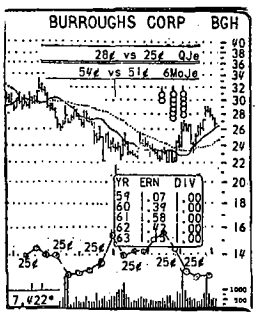


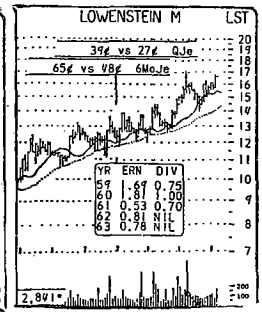












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Large chart of Amer. S. African courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003.
Small weekly charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.
P & F chart of Phillips courtesy of Chartcraft, Larchmont, New York.

This Letter completed 12 noon, Thursday, October 15.